

Is candlestick continuation patterns applicable in Malaysian stock market?

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Abstract. Technical analysis is deemed to be an anathema to the modern finance theory as it contradicts with the efficient market hypothesis, typically the weak form market efficiency which forbids the utilization of past prices and trading volume data to predict future market movement. However, the technical indicator of candlestick trading strategy is widely applied by traders for short term investment. This study thus investigates on the predictive power of candlestick charting which concentrates on the application of continuation patterns in Malaysian stock market from 2000 to 2014. Skewness adjusted t-test is employed to test the statistical significance of candlesticks' profitability. After taking into account the transaction costs, sub-sample, and out-of-sample test, the findings show that only Falling Window pattern after a prevailing downtrend shows predictive power with bearish signals indicated significantly during the 5-day holding period.

1 Introduction

The debating issue revolving around efficient market hypothesis and technical analysis has yet to be resolved until now. It is proposed that all sorts of readily available information including the public and private information have been fully incorporated into the prices of financial assets [1]. Hence, all three forms of market efficiency signify the impossibility to obtain abnormal returns in an efficient market despite any source of information received. Technical analysis on the other hand believes that market psychology can be traced by analyzing market trend through the aids of chart patterns and numerical calculation from past prices and trading volume data [2]. Technical indicators generate forecasted trading signals to assist traders in market timing. In particular, technical analysis is rejected by the weak form efficient market hypothesis which asserts that the use of historical information to forecast future market movement is useless.

The oldest known form of technical analysis is believed to be the Dow Theory which can be traced back to 1884. Notwithstanding the continuous criticisms from the proponents of efficient market hypothesis, technical analysis is indeed widely applied by traders in the real time securities market. Positive evidence which supports the application of technical analysis are even been accumulated [3, 4, 5, 6, 7]. Recent findings from behavioral finance

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